EQUITY COMPENSATION FOR KEY SERVICE PROVIDERS

Capital Interests vs. Profits Interests in LLCs

In the last few years, it is probably safe to say that more businesses have been organized as limited liability companies ("LLCs") than any other form of business entity. There are a variety of reasons for this trend but to a large extent it results from the fact that an LLC has most of the advantages of tax favored S corporations and partnerships, without having many of the disadvantages of those entities. Unlike S corporations, LLCs can have an unlimited number of members (owners), including U.S. and foreign individuals, corporations, partnerships and other LLCs. They can also have multiple classes of equity, both common and preferred. S corporations are only permitted to have voting and non-voting common stock. A lesser known benefit of LLCs is that LLCs, which elect to be treated as partnerships for income tax purposes, are permitted to issue both capital interests and profits interests to employees and other service providers for services rendered.

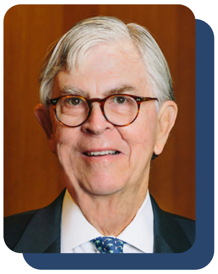
Many companies find that providing equity compensation to key employees is both necessary and advisable. These companies often cannot afford to pay cash compensation at "market" rates. In order to compete with larger, more established companies in recruiting experienced managers and skilled employees, offering some form of equity compensation (stock, options, etc.) can often make a difference between a recruiting success and failure. One of the challenges for employers is that many types of equity compensation can produce adverse tax consequences for the employees. An outright grant of stock is taxable to the employee. The issuance of stock options defers recognition of income by the employee, but the options typically require the employee to make an investment in the company at the time the options are exercised, and options which do not qualify as incentive stock options (so-called "ISOs") may also be a taxable event for the option holder when the option is exercised.

Capital Interests vs. Profits Interests

A capital interest in an LLC represents an ownership interest in the entire company, including but not limited to, future profits and distributions. Capital interests are typically issued for contributions of cash or property or for services when the value of the company is nominal. However, because a capital interest permits the holder to participate in all of the proceeds of a future sale or liquidation of the company, including appreciation in the value of assets that pre-dates issuance of the capital interest, the IRS takes the position that the issuance of a capital interest for services is currently taxable to the recipient.

Conversely, profits interests (which were first sanctioned by the IRS in Revenue Procedure 93-27) are an ownership interest in the company only with respect to future profits and distributions. The recipient of a profits interest has no right to participate in any appreciation in the value of the company or its assets that pre-dates the issuance of the profits interest. For that reason, the IRS views a profits interest as having no ascertainable value at the time of issuance and therefore, the receipt of the interest has no current income tax consequence for the service providers.

There are some disadvantages to profits interests. Technically, the holder of a profits interest cannot be a W-2 employee of the LLC to which he or she is providing services, though some "work-arounds" exist. However, the fact that profits interests can be granted without creating any current income tax liability for the recipient makes them a potentially valuable alternative for LLCs considering the grant of an equity interest in the company to key service providers. If you have questions about equity compensation issues, or other business matters, please contact PLDO Partner William F. Miller at 401-824-5100 or email wmiller@pldolaw.com.



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